

# SMITH & HOWARD FINANCIAL GROUP

*Comprehensive Wealth Management*

September 30, 2006

## Third Quarter 2006 Review

### I. Third Quarter Market Performance

Stock prices rose across the board in the third quarter with the Dow Jones Industrial Average closing just 44 points from its peak in 2000. The advance of 4.7% was its best quarter in 11 years. In addition to a record 18<sup>th</sup> consecutive quarter of double-digit earnings growth, a decline in interest rates and a pullback in commodities prices contributed to the surge.

Of interest to us and our investors is that this rally has become more broadly based. Unlike the past couple of years, where returns were largely limited to the energy sector, year-to-date returns on other sectors, including financials, consumer staples and other defensive areas, are positive as well. Value stocks with their heavy allocation to financials and energy are ahead of growth. Large-caps again outperformed small-caps, which we trimmed in the portfolio a while back.

The bond market also turned in a good quarter, as the rate on the ten-year Treasury bond fell from 5.15% to 4.64% during the quarter. This equated to a total return of 5%. Apparently, the market has concluded that the Fed is finished, or nearly finished, with the string of interest rate increases necessary to contain inflation.

The returns for several major stock, bond and alternative investment indices are shown below:

### Third Quarter 2006 Market Performance

Index	Quarter	1 Year
S&P 500	5.2%	8.7%
Russell 1000 Growth (Large Cap)	3.9%	6.0%
Russell 1000 Value (Large Cap)	6.2%	14.6%
Russell Mid Cap	2.1%	9.6%
Russell 2000 (Small Cap)	0.4%	9.9%
Russell Micro Cap	-0.7%	7.0%
EAFE (International) in US \$	3.4%	16.5%
MSCI Emerging Markets in US \$	4.1%	17.7%
Lehman 1-5 Year Government/Credit	4.6%	3.1%
Lehman Aggregate	3.8%	3.7%
Lehman High Yield	4.1%	8.1%
Dow Jones Wilshire REIT (Real Estate)	9.1%	28.2%
Credit Suisse/Tremont Long/Short Equity	1.6%	9.7%
Credit Suisse/Tremont Convertible Arbitrage	2.9%	11.2%
Credit Suisse/Tremont Managed Futures	-0.6%	-2.2%

Source: PSN

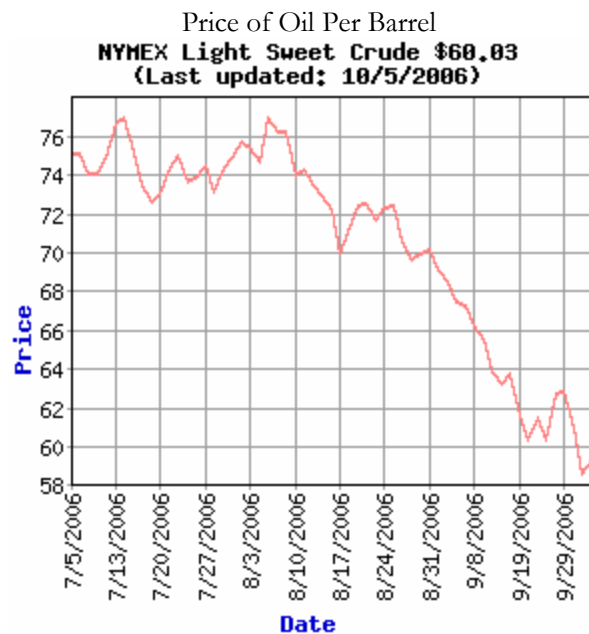
## II. Economic Review

### *Hard Landing, Soft Landing, or Keep on Keepin' On?*

The economy continued to expand in the third quarter, with GDP advancing an estimated 2.3% on a year-over-year basis. While still positive, this was a slowdown from the greater than 4% pace during the first half of the year.

The price of oil was the big story during the quarter, though because of its decrease, not increase, a welcome change for consumers. Since the high of \$77 per barrel in August, oil has plummeted to \$60, and is now back to the same level as the beginning of the year. Sources for the fall include a milder than predicted hurricane season, increasing supplies and the anticipation of slowing economic growth.

Analysts predict this drop in oil prices will be followed with below \$2 per gallon gasoline. This, coupled with natural gas prices that have retreated more than 50% from their recent high will act as a tax cut for consumers this winter. This is important because rising energy prices, along with the persistently strong housing market, were creating real difficulties for the Fed as it struggled with the possibility of uncomfortably high inflation.



The decline in energy and housing prices and the resultant drop in longer-term interest rates gave the Fed reason to pause for the second time in its interest rate hike campaign. The Fed Funds Rate, upon which most borrowing rates are based, now stands at 5.25%, and many economists forecast stable or even falling rates in the next 12 months. Observation of prior Fed cycles back to 1970 shows they begin cutting rates, on average, six months after the last rate increase. It is difficult to turn a \$13 trillion dollar economy on a dime.

*History doesn't repeat itself, but it does rhyme. - Mark Twain*

Good news aside, we have voiced a moderate level of concern in our last two letters about the possibility of runaway inflation (due to commodities and housing prices and a Fed that may have been behind the eight ball in raising rates). The Consumer Price Index has risen 3.8% in the past 12 months (through August), a little higher than the Fed would like to see. However, commodity prices have recently retreated somewhat, and housing is clearly in a marked slowdown. Indeed, home sales slowed during the quarter, and the median sales price of existing homes fell from year-ago levels for the first time in 11 years, and just the sixth time in 38 years. So it appears that the Fed has been successful in keeping inflation under control.

Our main worry about the economy stems not from any particular area of overvaluation, but from the inevitable reversion to the mean that will occur over time. For example, this economic expansion has now lasted 60 months (compared to a post-war average of 55 months). Certainly, some have lasted longer (the most recent lasted ten years), and it is possible that we will find the much sought after, but elusive, “soft landing”, and the expansion will continue. The running joke is that economists have predicted nine of the last five recessions. Particularly during this expansion, forecasts of impending slowdowns, or recessions, have become common predictions of the "experts". Eventually they will be right. One of the problems for economists is the increasing complexity of the economy. For instance, according to Brian Wesbury of First Trust Advisors, an estimated 600,000 people make a significant part of their income from selling on eBay. That is difficult for the government to capture in standard employment figures. But tax receipts do capture it – and they are up over 12% this year, the second year of double digit growth. Recession prediction is a tough business, and we know that the longer we go without a recession, the closer we are to having one. What we don't know (and neither does anyone else) is the exact timing of the next recession. A slowdown at least is apparent, however, and we believe our clients' portfolios are positioned appropriately.

### **III. Asset Allocation Review**

#### *Equities*

Our nearly four year preference for stocks over bonds has continued to add value in client accounts. The last shoe to drop is the anticipated shift from value and small-cap companies to the hugely neglected large-cap growth stocks, which are overweighted in the portfolio. The diversity of the portfolio to international and other areas has kept our stock portfolio returns in line with the market year-to-date, while taking on less risk, in our opinion.

Our outlook for equities is cautiously optimistic, with their reasonable valuations (about 15 times forward earnings), continued record corporate profits, still reasonable interest rates, and the great shape of corporate balance sheets. While higher short-term interest rates are having the desired effect of slowing down the red-hot housing market, corporate profits continue to grow and the recent trend down in energy prices can only help. We are always scanning the horizon for new opportunities, and with the Dow near an all-time high, we are carefully watching for any new developments that might cloud the currently rosy view on Wall Street.

### *Fixed Income*

As of quarter end, the yield curve remains flat to slightly inverted, with two-year Treasuries yielding 4.71%, and the ten-year yielding a similar 4.62%. Thus, our mantra continues of emphasizing short and intermediate-term, high quality bonds in the portfolio. We continue to be diversified across several sectors of the bond market, including international, which benefit from the falling dollar, and inflation-protected, which still look attractive. Municipal bonds are still a great bargain for most taxable accounts. No changes were made during the quarter.

### *Alternative Investments*

Our meaningful allocation to Alternative Investments (about 10-15% of most accounts) is a good hedge against a potential recession-led stock market decline. Risk control is an integral part of our portfolio management process, and these non-correlated investments tend to hold up well during such periods. They can perform well in good times also, as evidenced by their year-to-date performance. Our largest allocation is to hedged equity funds, which seek stock-like returns with less volatility, and hope to zig when the market zags. The smallest allocation is to real estate investment trusts (REITs), which continue to set record returns, but also record high valuations - neither of which can persist indefinitely.

Thank you for your interest in Smith & Howard Financial Group. Please contact us if you would like to speak with us about our comprehensive wealth management services or to talk about your existing account. As always, please let us know if there has been a change in your financial situation or your investment objectives since we last met with you, and feel free to call if you have any questions or comments.

Sincerely yours,

Michael R. DeWitt, CFA  
Portfolio Manager  
Director of Research